Ending "Too Big to Fail" – Part 2

By U.S. Senator Edward E. Kaufman
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Mr. President, I have come to the floor several times now to discuss the problem of "too big to fail," which I believe is the most critical issue to be addressed in any financial reform bill.

Financial institutions that are "too big to fail" are so large, so complex, and so interconnected that they can't be allowed to fail nor follow the normal corporate bankruptcy process because of the dire threat that would pose to the stability of the overall financial system.

The largest six bank holding companies – Bank of America, JPMorgan Chase, Citigroup, Wells Fargo, Goldman Sachs, and Morgan Stanley – are certainly "too big to fail." The term may also cover a larger set of institutions. After all, last year's much-vaunted stress tests of the largest bank holding companies covered 19 institutions. And even that exercise didn't include many other systemically significant nonbank financial institutions, including Fannie Mae and Freddie Mac, insurance companies, derivative clearinghouses and hedge funds.

While many in government and industry want to eliminate the term "too big to fail," the fact is that these "too big to fail" financial institutions are bigger, more powerful and more interconnected now than ever before. Only 15 years ago, the six largest U.S. banks had assets equal to 17 percent of overall GDP. The six largest U.S. banks now have total assets estimated in excess of 63 percent of our GDP.

While some still argue that there are benefits to having very large financial conglomerates, virtually everyone agrees that the problem of "too big to fail" still needs to be addressed. The disagreement is how this should done.

I was interested to hear Senator McConnell on the floor yesterday say we must never use taxpayer money again to bail-out too big to fail institutions. But no one wants to do that. The question is what is the solution to prevent these institutions from failing in the first place? The other party has put forward no solution, and doing nothing is by far the worst solution of all.

The Minority Leader came to the floor today and said that the bill before the Senate is good for Wall Street and bad for Main Street. That is simply an astounding statement to make, Mr. President. Main Street wants Congress to act! Main Street wants Congress to ensure that Wall Street never engages in reckless behavior again. And yet what solution does the Minority Leader offer?

Despite the experience of Lehman Brothers, the Minority Leader apparently believes we should do nothing and let these megabanks fail when they take risks that go wrong. The Minority Leader said yesterday, and I quote: ”The way to solve this problem is to let the people who make the mistakes pay for them. We won’t solve this problem until the biggest banks are allowed to fail.” His answer is that resolution of "too-big-to-fail" banks needs to be dealt with through the bankruptcy process. In my view, that approach is dangerous and irresponsible.

If we do nothing, and wait for another crisis, future presidents – whether Republican or Democrat – will face the same choices as President Bush: whether to let spiraling, interconnected too-big-to-fail institutions, like AIG, Citigroup and others, collapse in a contagion, sending the economy into a depression, or step in ahead of bankruptcy and save them with taxpayer money. If that happens, the choice of allowing bankruptcy will mean tremendous economic pain for Main Street America. And so some Congress of the future will similarly be faced with another TARP-like decision, which in the fall of 2008 many in both parties believed they had no choice but to support, including the Minority Leader.

Bankruptcy Law is Not the Answer

Mr. President, relying on bankruptcy law is not the answer. The approach by many conservatives and those on the other side of the aisle is simply to “let ‘em fail” and let U.S. bankruptcy law – where shareholders get wiped out and creditors take a haircut – reimpose the discipline in the financial system that was lacking in the run up to the crisis.

For example, Peter Wallison and David Skeel have argue in the Wall Street Journal that “the real choice before the Senate is between the FDIC and the bankruptcy courts. It should be no contest, because bankruptcy courts do have the experience and expertise to handle a large-scale financial failure. This was demonstrated most recently by the Lehman Brothers bankruptcy."

If bankruptcy was a cure in Lehman Brothers, it was one that almost killed the patient – the U.S. economy. When former Treasury Secretary Hank Paulson decided to let Lehman Brothers go into bankruptcy, our global credit markets froze and creditors and counterparties panicked and headed for the hills. Instead of imposing market discipline, it only prompted more bailouts and almost brought down our entire financial system. It ultimately took 18 months to close out the case on Lehman Brothers, an eternity for financial institutions that mark to market and fund their balance sheets on an interday basis.

Bankruptcy is an even more unattractive option when one considers that Lehman was an investment bank, while today's megabanks operate under the bank holding company umbrella. It is virtually impossible to have an integrated resolution of a large and complex bank holding company. The bank subsidiary would go into FDIC resolution, the insurance affiliates would go into state liquidation procedures, the securities affiliate would go into Chapter 7, while other affiliates and the overall holding company would go into Chapter 11. A plan this unwieldy is no plan at all.

In fact, the only way to truly eliminate the problems of "too big to fail" banks is for Congress to act. It is true that I believe we should go farther than the current bill. I would break these big banks apart, thus limiting their size and leverage.

Given the consequences of failing to do enough to prevent another financial crisis, the safest thing to do today is for Congress to put an end to too big to fail. If you believe these mega-banks are too big, if you reject the choice of bankruptcy that will lead to a recession or depression, then breaking them up is the logical answer. That's the only way that greatly diminishes the future probability of financial disaster.

The Great Depression of the 1930s must be avoided at all costs. Two years ago, permitting Lehman Brothers to enter bankruptcy brought about the Great Recession, the most painful economic downturn this country has seen in decades.

If we were to let other institutions fall into bankruptcy, adopting the Minority Leader's approach, the horrors our economy would have faced would make the realities of the past two years pale in comparison.

I certainly don't want to rely on bankruptcy to break the boom-bust-bailout cycle. I believe Congress should break the cycle today. We should not follow an abdication of regulatory responsibility with an abdication of democratic government. As representatives of the people most hurt by the financial crisis, Congress should act decisively to ensure that we benefit again from decades of financial stability, not do nothing, which most assuredly would leave us to live on the precipice of another financial disaster, as the Minority Leader would have us do.

Conclusion

Mr. President, we need a full and straightforward debate in the Senate about what Congress must do. In my view, the mere existence of "too big to fail" institutions perpetuates a long cycle of boom, bust and bailout.

Instead of hopelessly trying to impose order and discipline in a chaotic crisis, we need to clearly, decisively, and preemptively deal with the problem of "too big to fail" now. As Senator Levin pointed out this week when he kicked off the Permanent Subcommittee's hearings on its investigation on the financial crisis, there are many eerie parallels between this crisis and the one in the late 1920s and early 1930s. In both cases, bankers were derelict in their duties while drawn to disruptive and excessive speculation, fueled in part by their compensation arrangements.

In the 1930s, in response to these problems, we built an enduring regulatory framework that put our entire financial system on stable footing for decades. It was a simple and elegant model where banks were given the benefit of funding themselves with federally insured deposits in exchange for tight supervision and a prohibition against securities activities. It focused on real prevention instead of wishful cures.

We simply can't afford another financial meltdown. The choice is clear. But the worst thing we can do is take the dangerous risk of doing nothing.

To me, the choice that is best for the American people is clear.